04960467.LOF

DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS

NUMBER 96-0467

SALES AND USE TAX
FOR THE PERIOD 1992–94

NOTICE: Under IC § 4-22-7-7, this document is required to be published in the *Indiana Register* and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the *Indiana Register*. The publication of this document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

At the protest hearing, the taxpayer withdrew one issue from consideration. The remaining two issues are as follows:

I. Sales and Use Tax—Exemptions—Tangible Personal Property Consumed in Direct Production—Water Treatment Chemicals and Anti-Scale Water Treatment Chemicals

Authority: IC § 6-2.5-3-4(a)(2) (1988 and 1993), IC § 6-2.5-5-5.1(b) (Supp. 1992 and 1993); 45 IAC § 2.2-5-12 (1992)

The taxpayer argues that the auditor erred in assessing use tax on certain water treatment chemicals that it claims are exempt from that tax.

II. Sales and Use Tax—Exemptions—Tangible Personal Property Used to Produce Machinery, Tools or Equipment—Computers, Art and Graphics Software and Peripheral Equipment

Authority: IC §§ 6-2.5-3-4(a)(2) and -5-4 (1988 and 1993); IC § 6-2.5-5-3(b) (Supp. 1992 and 1993); *Indiana Dep't of State Revenue v. Cave Stone, Inc.*, 457 N.E.2d 520 (Ind. 1983); *Indiana Dep't of State Revenue v. Colpaert Realty Corp.*, 109 N.E.2d 415 (Ind. 1952); *Department of Revenue v. United States Steel Corp.*, 425 N.E.2d 659 (Ind. Ct. App. 1981); *Indiana Dep't of State Revenue v. American Dairy of Evansville, Inc.*, 338 N.E.2d 698 (Ind. Ct. App. 1975); 45 IAC §§ 2.2-5-8(c) and (g), -5-11(c) and (d) (1992)

The taxpayer also asserts that the auditor erred in assessing use tax on certain computers, art and graphics software and peripheral equipment, which, the taxpayer contends, are exempt.

STATEMENT OF FACTS

During the audit period the taxpayer, a Delaware corporation, operated two plants, one of which was in Indiana, at which it manufactured plastic products for sale to other manufacturers or retailers as component packaging for their products. The taxpayer's products included containers, lids, overcaps for aerosol spray products, cups and specialty items (e.g., plastic Halloween pumpkins and Easter baskets).

The taxpayer created the product by injecting hot plastic into a mold, the cooling of which the taxpayer accelerated by circulating water through the mold and production equipment, hardening the product in the process. Once the temperature of the production equipment, the mold and the product dropped to a pre-set level, the mold opened automatically and the product was ejected. The taxpayer bought a computer during the audit period that monitored the production equipment and sounded an alarm if it malfunctioned. However, the computer did not control the operation of the production equipment.

A chemical put into the water in the circulatory system for the molds and molding production equipment insured that they cooled consistently. A separate chemical minimized corrosion of or sedimentation buildup in that system's water pipes. The taxpayer also used the same two chemicals in the water circulated through the chillers in an air conditioning system that it installed in the molding building during the audit period. (The latter system was on a separate loop from those used to cool the molds and mold production equipment and the air conditioning system of the room in which the taxpayer conducted the printing process, discussed below.) The auditor identified these chemicals in the Audit Summary as "water treatment chemical" and "anti-scale water treatment chemi-

cal," respectively, and the Department will hereafter use the same terms to identify them in this Letter of Findings.

A buyer of containers, lids, overcaps and cups usually wanted its logo, advertising, ingredient descriptions or some other specialty design to appear on these plastic products. To do so, the taxpayer had to prepare a set of plates, almost always customized, for the artwork the buyer wanted on the product.

The buyer submitted the desired artwork to the taxpayer, either by hard copy or digital data file. The taxpayer then transferred the artwork into its computers, either by use of a scanner in the case of hardcopy or by disk if the artwork or graphics was in a digital file. Next, the taxpayer used art and graphics software to manipulate and, if necessary, to modify, the artwork to fit the surface area available on the plastic product on which it was to appear (including a factoring-in of any tapering of that product), and to separate the colors. Then the taxpayer prepared a proof of the manipulated artwork or graphics for the buyer's review. Once the taxpayer received the buyer's approval, the digital file or files containing the modified artwork were transferred to an imager for the preparation of a set of photographic negatives, one for each of the separated colors. (During the audit period the taxpayer contracted out this task because it did not own an imager.) The taxpayer then used those negatives to prepare a black-and-white proof of the artwork for comparison to the buyer-approved proof to insure accuracy and quality. The negatives were then used to create a set of plates, one for each color, and to replace any plates that were damaged or worn out during production.

Finally, the taxpayer used the plates to put the artwork on the plastic product. The taxpayer put the graphics or artwork on the product in a black-and-white proof and a black-and-white template on which the colors were superimposed one by one until the completed color artwork appeared on the plastic product. The plates are flexible pieces of metal on which the image in question appears in direct, rather than reversed- or mirror-image, form, and has identical sets of holes punched on either end. These plates were bent around and fastened onto a circular drum. The ink from the plate was then transferred in reverse- or mirror-image to another drum with which it was in contact. The second drum then applied the reverse image directly onto the plastic product.

The field auditor assessed use tax on 14.1% of all of the water treatment and anti-scale water treatment chemicals used in the mold cooling system and the air conditioning system for the building in which the plastic production equipment was located. The auditor arrived at this percentage from a summary analysis the taxpayer provided of its water usage through the two systems, which indicated that it used 14.1% of its water in the air conditioning cooling towers. Additionally, the auditor assessed use tax on the computers, peripheral equipment and supplies used in the pre-printing design modifications to the artwork printed on the product. The taxpayer timely protested the parts of the assessments concerning the computers, peripheral equipment and supplies used to modify the artwork, as well as the parts of the assessments concerning the water treatment chemicals.

I. Sales and Use Tax—Exemptions— Tangible Personal Property Consumed in Direct Production—Water Treatment Chemicals and Anti-Scale Water Treatment Chemicals

DISCUSSION

IC § 6-2.5-3-4(a)(2) (1988 and 1993) exempts from use tax the storage, use and consumption of any tangible personal property that is wholly or partly exempt from sales tax under any part of IC ch. 6-2.5-5 (except IC § 6-2.5-5-24(b), which is not in issue in this dispute). IC § 6-2.5-5-5.1(b) (Supp. 1992 and 1993) states in relevant part that

> [t]ransactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for direct consumption as a material to be consumed in the direct production of other tangible personal property in the person's business of manufacturing, processing, refining, repairing, mining, agriculture, horticulture, floriculture, or arboriculture.

Id. The taxpayer argues that its use and consumption of the water treatment and anti-scale water treatment chemicals were tax-exempt because these items were essential to its production of a final plastic product. It claims that both chemicals insured consistent water flow through the cooling system for the molds and molding production equipment and for the air conditioning systems in both the molding and printing buildings. The taxpayer contends that by insuring such consistent water flow, both chemicals minimized not only humidity buildup in the molds, but also any variances in product from the buyer's specifications and any consequential increases in rejections of such non-conforming product on quality control grounds.

The Department observes at the outset that the auditor by necessary implication found 85.9% of the water treatment and anti-scale water treatment chemicals to be exempt by assessing use tax on only 14.1% of those chemicals. The auditor correctly indicated in the part of the Audit Summary that discussed the molding room air conditioning and ventilation systems that neither of the latter was essential or integral to the molding process. The same logic applies to the 14.1% of the water treatment and anti-scale water treatment chemicals that the taxpayer's own summary analysis found were used and consumed in the molding room air conditioning system.

FINDING

The taxpayer's protest is denied as to this issue.

II. Sales and Use Tax—Exemptions—Tangible Personal Property Used to Produce Machinery, Tools or Equipment—Computers, Art and Graphics Software and Peripheral Equipment

DISCUSSION

The taxpayer argued to the auditor, and argues again in this protest, that the computers, software and peripheral equipment used to modify the buyers' respective artwork are essential and integral to the taxpayer's production process. The field auditor disagreed, finding the computers, software and peripheral equipment used in this process to be taxable. The auditor cited 45 IAC § 2.2-5-8(g), Example (7), which states that "computer-aided design is a non-exempt function[,]" *id.*, as supporting authority. That provision is part of the regulation that interprets IC § 6-2.5-5-3(b). Thus, both the taxpayer and the auditor have framed the issue concerning these items on the assumption that IC § 6-2.5-5-3(b) is the controlling law. As the Department will explain below, that assumption was only indirectly correct. However, IC § 6-2.5-5-4 (1988 and 1993), the exemption statute that most nearly applies to the present issue, is similarly worded to, refers to and requires nearly the same analysis as IC § 6-2.5-5-3(b). The regulation that implements IC § 6-2.5-5-4, 45 IAC § 2.2-5-11, incorporates IC § 6-2.5-5-3(b) as interpreted by parts of 45 IAC § 2.2-5-8. When all of these authorities are applied to the use of the present items they show that this property remains taxable.

IC § 6-2.5-5-3(b) states that

> [t]ransactions involving manufacturing machinery, tools, and equipment are exempt from the state gross retail tax if the person acquiring that property acquires it for *direct* use in the *direct* production, manufacture, fabrication, assembly, extraction, mining, processing, refining, or finishing of other tangible personal property.

Id (emphases added). The statute imposes what reported Indiana judicial opinions have come to call the "double direct" test. The machinery, tools or equipment for which a taxpayer claims this exemption product, but also must be "*direct[ly]* use[d] in the *direct* production" of the finished product. IC § 6-2.5-5-3(b) (emphases added). The Indiana Supreme Court defined the adjective "direct" nearly fifty years ago in a gross income tax opinion as meaning "*immediate*; proximate; without circuity." *Indiana Dep't of State Revenue v. Colpaert Realty Corp.*, 109 N.E.2d 415, 422 (Ind. 1952) (emphasis added) (hereafter "*Colpaert Realty*"). After the General Assembly enacted the sales and use taxes, the Indiana Court of Appeals extended this definition to "direct" as used in the terms "direct use" and "direct production" in former IC § 6-2-1-39(b)(6) (1971) (repealed 1980), from which current IC §§ 6-2.5-5-2 to -4 derive. *E.g., Indiana Dep't of State Revenue v. American Dairy of Evansville, Inc.*, 338 N.E.2d 698, 700 (Ind. Ct. App. 1975) (quoting *Colpaert Realty*; hereafter "*American Dairy*").

Indiana Dep't of State Revenue v. Cave Stone, Inc., 457 N.E.2d 520 (Ind. 1983) (hereafter "*Cave Stone*") used these opinions to establish the definitions of "direct use" and "direct production" that are still used to interpret and apply IC § 6-2.5-5-3(b). The "direct use" to which the statute refers must be "by the purchaser, not some other entity[.]" 457 N.E.2d at 525. Concerning "direct production" *Cave Stone* goes on as follows:

> We believe that the Court of Appeals, Fourth District, in *Department of Revenue v. U.S. Steel [Corp.]*, (1981) Ind.App., 425 N.E.2d 659 (transfer denied) [hereafter "*U.S. Steel*"], has determined the correct analysis for construing the statute in question. The court therein strictly construed the meaning of "direct production" and stated that the test for directness requires the equipment to have an "*immediate link* with the product being produced." [*Id.* at 662.] The court reasoned:
>
> > "Manufacturing equipment may be either directly or indirectly used in production, and the legislature plainly intended to limit the exemption to those items directly a part of production.... Our decisions hold the logical and practical distinction between directness and indirectness can be found where the equipment actually exercised some *immediate effect* on the product." (citations omitted). "We do not believe this strict construction has defeated the intention of the statute." (citations omitted). *Id*. at 662.

457 N.E.2d at 525 (emphases added by the Department; omissions by the Supreme Court).

The year after the Court of Appeals decided *U.S. Steel*, the Department included that opinion's "immediate effect" requirement in the recodified regulations for the production-related exemptions, including 45 IAC § 2.2-5-8, which implements IC § 6-2.5-5-3(b). LSA Doc. No. 82-86(F), sec. 1, 6 Ind. Reg. 8, 29-37 *passim* (1983), codified as further amended as 45 IAC §§ 2.2-5-6 to-5-13. Specifically, those regulations require that tangible personal property claimed as exempt "have an *immediate effect* on the article being produced." *E.g.*, 45 IAC § 2.2-5-8(c) (emphasis added).

The rules of statutory interpretation also apply in construing regulations. *Miles, Inc. v. Indiana Dep't of State Revenue*, 659 N.E.2d 1158, 1164 (Ind. Tax 1995). "In construing statutes [and regulations], words and phrases will be taken in their plain or ordinary and usual sense unless a different purpose is clearly manifest by the statute [or regulation] itself, …." *Colpaert Realty*, 109 N.E.2d at 418-19 (quoting a predecessor to IC § 1-1-4-1(1) (1988, 1993 and 1998)). "A fundamental canon of statutory construction is that, unless otherwise defined, words will be interpreted as taking their ordinary, *contemporary*, common meaning." *Perrin v. United States*, 100 S.Ct. 311, 314 (U.S. 1979)(emphasis added). The ordinary, contemporary, common meaning of a non-technical word is the

meaning found in English-language dictionaries in existence at the time the statute was enacted or the regulation was promulgated. *See id.* The Department's analysis of Indiana Tax Court opinions indicates that that court is most likely to refer to WEBSTER'S THIRD NEW INTERNATIONAL DICTIONARY (hereafter "WEBSTER'S THIRD") to define a non-technical word or phrase in a statute or regulation. WEBSTER'S THIRD defines "immediate" in relevant part as "acting or being without the intervention of another object, cause, or agency : DIRECT, PROXIMATE <the [immediate] cause of death>." *Id.* at 1129, definition 1a (1976 ed.). "Immediate" as used in the regulation is thus synonymous with "direct" as defined by *Colpaert Realty* and *American Dairy* and as used in former IC § 6-2-1-39(b)(6) and in IC § 6-2.5-5-3(b). The term "direct production" as used in those statutes and as construed in *U.S. Steel* and *Cave Stone* therefore means "production without the intervention of another object, cause or agency."

Lastly, for the machinery, tools or equipment used in direct production to be exempt under IC § 6-2.5-5-3(b), such production must be of "other tangible personal property," *id. Cave Stone* interpreted former IC § 6-2-1-39(b)(6), which included language substantially identical to that in the present statute, as "circumscrib[ing] all of the operations by which *the finished product* is derived." 457 N.E.2d at 524 (emphasis added). The term "other tangible personal property" as used in the context of the statute thus refers to that finished product.

When these definitions of "immediate effect," "direct production" and "other tangible personal property" are applied to the computers, software and peripherals used in the art and graphics process, it becomes clear that these items are not exempt under IC § 6-2.5-5-3(b). The taxpayer employed the claimed items in the first three steps of the art and graphics process. The taxpayer first used the computers and software to convert the graphics or artwork its customer supplied into a digital data file or files. Second, it manipulated or modified the file/s to fit the artwork or graphics within the dimensions of the surface area available on the plastic product. Third, it prepared a proof of the modified graphics or artwork for the customer's approval. Fourth, after getting that approval, the taxpayer during the audit period contracted for a third party to prepare a set of photographic negatives from the data file/s. Fifth, these negatives were in turn used to produce a set of direct-image plates. Sixth, these plates were then used to apply the various colors of ink used in the artwork to a drum in reverse image, which in turn applied that ink to the plastic product in direct image. Machinery, tools and equipment that the taxpayer used at six degrees of separation from the finished product had no "immediate effect" on that product and were not used in its "direct production."

Thus, both the taxpayer and the field auditor were wrong to assume that IC § 6-2.5-5-3(b) and 45 IAC § 2.2-5-8 were the primary authorities governing whether the art and graphics computers, software and peripherals were taxable or exempt. Those authorities did not directly apply to this question because the taxpayer did not use the disputed items in the direct production of the finished product. However, this is not to say that IC § 6-2.5-5-3(b) and 45 IAC § 2.2-5-8 were wholly inapplicable; they were and are *indirectly* applicable under another exemption. IC § 6-2.5-5-4 states that

> [t]ransactions involving tangible personal property are exempt from the state gross retail tax if the person acquiring the property acquires it for his *direct* use in the *direct production of the machinery, tools, or equipment* described in section 2 or 3 of this chapter[i.e., IC §§ 6-2.5-5-2 or -3].

Id (emphases added). In other words, if a taxpayer itself produced the machinery, tools or equipment that it in turn used in the direct production of its finished product, then not only are the machinery, tools or equipment exempt, but so is the tangible personal property used to produce them. Thus, a taxpayer's claim that tangible personal property is exempt under IC § 6-2.5-5-4 indirectly depends on the taxpayer's ability to claim the exemption under IC § 6-2.5-5-3(b) for the product of the taxpayer's use of that property. As discussed above, the taxpayer's entitlement to claim the latter exemption depends on whether its use of that product satisfies the *Cave Stone/U.S. Steel* "immediate effect" test, as codified in 45 IAC § 2.2-5-8, concerning the finished product.

However, the "double direct" and "immediate effect" tests apply directly under IC § 6-2.5-5-4 as well. The above quotation of IC § 6-2.5-5-4 shows that it, like IC § 6-2.5-5-3(b), uses the terms "direct use" and "direct production[.]" Like 45 IAC § 2.2-5-8(c), subsection (c) of 45 IAC § 2.2-5-11, the regulation implementing IC § 6-2.5-5-4, requires that the tangible personal property claimed as exempt "have an *immediate effect* upon the article being produced or manufactured.

"[T]he same word[s] used in the same manner in different places in the same statute [or rule are] presumed to be used with the same meaning[.]" *Department of Treasury v. Muessel*, 32 N.E.2d 596, 599 (Ind. 1941). The General Assembly originally enacted what became IC §§ 6-2.5-5-2 to -4 as different clauses within the same paragraph. Gross Retail and Use Tax Act, ch. 30 (Spec. Sess.), sec. 4, 1963 Ind. Acts 60, 64 (adding para. 39(b)(6) to the Gross Income Tax Act, 1933 Ind. Acts ch. 50), formerly codified as IC § 6-2-1-39(b)(6) (1971 and 1976) (repealed 1980). Each clause of the former exemption required that the property claimed as exempt "be directly used by the purchaser in the direct production" of the finished product or property to be used in the direct making of that product. *Id.* They were also each part of the same section of the 1980 law that recodified the Gross Retail and Use Tax Act, although the legislature did change "directly used" to "direct use" and separated the exemptions into their present sections in the Indiana Code. P.L. No. 52, sec. 1, 1980 Ind. Acts 590, 601. Similarly, the Department added the reference to "immediate effect" to 45 IAC § 2.2-5-11(c) in 1982, in the same regulatory promulgation in which the Department made the same respective changes to 45 IAC § 2.2-5-8. *Compare* LSA Doc. No. 82-86(F), sec. 1, 6 Ind. Reg. at 31-33 *passim with id.* at 35. As discussed earlier, the use of these terms in 45 IAC § 2.2-5-8, and other regulations that interpret the exemptions for tangible personal property used to produce finished products, administratively codified the *Cave Stone/U.S. Steel* "immediate effect" test. The use of the same terms in 45 IAC § 2.2-5-11 thus indicates that the Department intended, and intends, these judicial rules also to apply directly under IC § 6-2.5-5-4 to the production of machinery, tools or equipment

that a taxpayer then uses to produce a finished product. However, as noted above, IC § 6-2.5-5-4 also uses the "double direct" test indirectly through IC § 6-2.5-5-3(b).

The Department has concluded that the products of the use of the arts and graphics computers, software and peripherals are not "machinery, tools or equipment. The Gross Retail and Use Tax Act does not include any definitions of the words "machinery," "tools" or "equipment." The Department has examined definitions of these words, or of terms in which they appear, in statutes and judicial opinions dealing with other areas of substantive law, and has concluded that these definitions would be of at best limited use in interpreting IC §§ 6-2.5-5-3(b) and -4. Accordingly, the Department must give "machinery," "tools" or "equipment" their plain, or ordinary and usual, meanings as they were understood when the General Assembly passed the Gross Retail and Use Tax Act in 1963. The original, 1961 edition of WEBSTER'S THIRD had been published shortly before. The relevant definitions in that dictionary for the nouns "equipment," "machine," "machinery" and "tool" appear at 768, 1353, 1354 and 2408 thereof, respectively. It is plain to the Department that color proofs and computer data files, whether provided to the third-party preparer of the negatives via floppy disks or modem, do not fit any of these definitions. This is the case because the common denominator of equipment, machines and tools, which the definitions in WEBSTER'S THIRD impliedly articulate, is that people use them in economic *activities*. In the production context in particular, people use them as a means to *act upon* other tangible personal property. By contrast, the role of the data files was passive; they were *acted upon* to create the negatives. That is to say, they are intermediate objects, rather than the means, of production.

It is also important to remember that the taxpayer did not use the arts and graphics computers, software and peripherals for which it claims exemption to prepare the sets of negatives and plates. Even assuming that either of the latter items would fit the definitions of "equipment" or a "tool" and meet the "double direct" test as to the finished product, those items were created later in the production process, using other tangible personal property (e.g., an imager) to do so. The arts and graphics computers, software and peripherals therefore were not used in the direct production of the sets of negatives and plates. Rather, those direct products were the color proofs of its buyers' modified artwork, and any computer disks the taxpayer may have prepared containing data files of that artwork, used to prepare the sets of negatives and plates.

Even if the data files somehow did qualify as machinery, tools or equipment, they would still fail to meet the "double direct" test as to the finished product. During the audit period any data files of modified artwork were used by a third-party contractor, rather than directly by the taxpayer. The data files were not used in the direct production of the finished product. Instead, the files were used to prepare sets of negatives, which the taxpayer in turn used to prepare sets of plates. In this connection, the Department notes that subsection (d) of the same regulation refers to 45 IAC § 2.2-5-8 for the criteria to apply, and examples to which to refer, as to whether an activity meets the immediate effect test under IC § 6-2.5-5-4. The latter regulation includes 45 IAC § 2.2-5-8(g), Example (7), on which the field auditor relied, and which states in substance that computer-aided design has no immediate effect on the article being produced and that such use of computers and peripheral equipment remains

taxable. The arts and graphics computers, software and peripherals therefore had no immediate effect on the immediate product, as 45 IAC § 2.2-5-11(c) also requires. Thus, the auditor's application of 45 IAC § 2.2-5-8(g), Example (7) was right in substance. Accordingly, the Department finds that the arts and graphics computers, software and peripherals were not exempt under IC § 6-2.5-5-4.

FINDING

The taxpayer's protest is denied as to this issue.

SLK/PE/MR--000812